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SUBJECT: EU Ends Excessive Deficit Procedure

¶1. (U) Summary: On July 8, EU Finance Ministers formally ended a four-year old excessive deficit procedure (EDP) regarding Poland. This lifts a cloud over some EU subsidies, brings Poland closer to Euro adoption, and gives the Polish government more breathing room for decisions on aid programs and debt forgiveness, including debt owed by Iraq. In May, the European Commission (EC) recommended ending the EDP, after concluding that Poland's general government budget deficit had been brought below the EU limit of three percent of GDP "in a sustainable and credible manner". End summary.

¶2. (U) Article 104 of the European Community Treaty obliges EU-member countries to avoid excessive deficits. The Maastrict Treaty limits the general government budget deficit to three percent of GDP. When Poland joined the EU, its general government deficit exceeded four percent of GDP. Consequently, on July 5, 2004 the EC initiated the EDP with respect to Poland and five other countries. At the time, the Polish government asserted the EC had relied upon "invalid" data.

¶3. (U) The Polish government viewed the EDP as unfair punishment for introducing structural reforms, such as changes to the pension system, and had been pushing to end the EDP for years. In 2006, Poland claimed that its general government deficit had fallen to 2.2 percent of GDP. However, the EC concluded then that the improvement in the budget situation was a temporary phenomenon, resulting from counting open pension fund contributions as part of government revenue. Eurostat, the EU's statistical agency, forced Poland to stop using that accounting method in July 2007. Discontinuing the practice pushed the official deficit back above three percent.

¶4. (U) Starting in the second quarter of 2007, high GDP growth led to improving Polish public finances, as economic growth translated into higher inflows from corporate and value-added taxes. The EC noted that the 2007 deficit was just two percent of GDP. In fact, in the first four months of 2008, Poland recorded a budget surplus, although in May the budget slipped back into deficit. The EC stated that the deficit is likely to increase to 2.5% of GDP in 2008, but felt the EDP could be ended given a favorable outlook for stability in Poland's public finances.

¶5. (U) The Finance Minister's decision removes a cloud over some funding Poland received from the EU, and clears away an obstacle to Poland's applying for membership in the European Monetary Union. However, many commentators believe provisions of the Polish constitution, such as those regarding the central bank, should be amended before Poland enters the Exchange Rate Mechanism (ERM II), a precursor to Euro adoption. Amending the constitution would require support from Euro-skeptics in the opposition PiS party. The current market expectation for Euro adoption is 2012-2013 at the soonest.

¶6. (SBU) Comment: While the end of the EDP is good news for Poland, several structural problems still present serious challenges to Polish public finances. Chief among these are early retirement

and healthcare costs. Due to the many incentives to retire, only 54 percent of Poland's potentially active labor force is employed, compared to about 70 percent in the EU as a whole. Meanwhile the farming sector is exempt from contributing equally with other Poles to social insurance schemes. The result is proportionately more retirees in Poland than in other EU countries and a smaller revenue base from which to draw taxes. As growth slows, addressing these issues will become even more pressing. End comment.

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